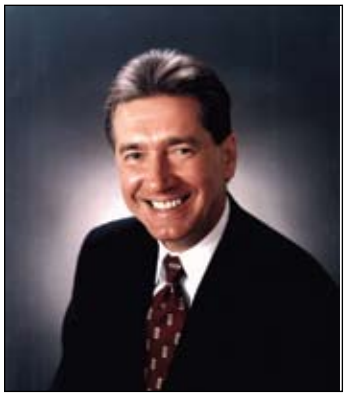
Worker Classification Issues In Professional Practices



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Professionals, surprisingly, can often end up classified as employees.

UNDER WHAT CIRCUMSTANCES can a professional worker be properly classified as an employee or independent contractor for federal tax purposes? The following three examples represent common situations where worker classification applies to professional practices.

1. The new professional (often forming a new entity, typically an S-corporation) renders professional services to the existing practice owner's entity. The new professional has not yet purchased any interest of the existing owner's practice, although a future purchase may be contemplated;
2. The retiring professional renders post-closing professional services, typically for six months to a year, following the practice sale to the new owner; and
3. The new professional purchases part of the old professional's practice and the new professional and old professional form a limited liability company ("LLC") through which professional services are rendered. Usually, each professional is also the sole shareholder of an existing C-corporation or a newly-formed S-corporation that becomes a member of the LLC and through which professional services are provided to the practice.

With limited exceptions, in each situation our conclusion is that the professional is an employee of the professional practice, the entity actually providing services to the public.

Practice consultants frequently question the audit risk in these scenarios where the independent contractor pays its, his, or her applicable self-employment taxes, thereby making the government whole as to those combined taxes that would be paid in an employer/employee setting. The actuality is that the IRS can and will assess Federal income tax, FICA, and FUTA, as well as penalties and interest against the business or practice for misclassification and the deductions for the misclassified independent contractor would, for the most part, be lost. Our advice would be not to take unnecessary risks.

The employment tax cases back up this conclusion and the government's claim against the practice to pay the worker's taxes. Assuming that the worker did pay its, his, or her applicable taxes, the government's successful claim against the practice can result in double taxation with the government collecting the same tax twice. There may be a direct credit to the employer under Internal Revenue Code ("IRC") section 3402(d) for the worker's income taxes that have already been paid by the worker. Tax Management Portfolios, BNA, Inc., 391-3rd *Employment Status – Employee v. Independent Contractor*, Helen Marmoll, Esq., p.A-160. Notwithstanding this, the economic impact of misclassification is very expensive to the practice not only in terms of unpaid taxes, fines, and interest, but also due to the time, emotional toll, and advisory costs of a defense. Misclassifying a worker(s) can also have very negative affects upon retirement plans, including disqualification, not to mention the ability to include the worker in the health insurance plan of the practice. *Vizicano v. Microsoft Corp.* , 120 F.3d 1006 (9th Cir. 1997), *cert. denied*, 522 U.S. 1098 (1998) (1998).

From the worker's standpoint, business expenses of a reclassified employee generally would be nondeductible, subject to the two percent of adjusted gross income limitation under IRC section 67. (References to "IRC" are to the Internal Revenue Code of 1986, as amended.) Also see *Independent Contractor or Employee?* Training Materials, Department of the Treasury, Internal Revenue Service, October 30, 1996, Training 3320-102 (10-96) TPDS 842381 p. 1-5, *available at* www.irs.gov/pub/irs-utl/emporind.pdf (Hereinafter "Training Materials".) For example, in *Maimon v. Commissioner*, T.C. Summary Opinion 2009-53 (2009), the court held that a doctor was an employee of a medical practice. The doctor sought to be recognized as an independent contractor once he was faced with a large expense resulting from an employment-related lawsuit. Because he was found to be an employee of the practice, he was forced to report his compensation on Form 1040, line 7 and was not entitled to deduct the claimed business expenses on Schedule C. Instead, he was forced to claim the expenses on Schedule A as unreimbursed employee business expenses subject to the aforementioned two percent limitation for miscellaneous expenses. As noted, a worker who is reclassified as an employee cannot maintain an employer-sponsored retirement plan such as a 401(k) plan.

In its 1996 Training Manual referenced above, the IRS recognized that the well-known 20 factor test is an analytical tool and not the legal test for determining worker status. Per the Training Manual and more recent IRS rulings and publications, it has been made clear that the legal test is whether there is a right to direct or control the means and details of the work. *Id.* p. 2-3; IRS Publication 1779 (Rev. 8-2008); Priv. Ltr. Rel. 2003-23-022 (Feb. 24, 2003). The test divides control into three categories: behavioral control, financial control, and the relationship of the parties. *Id.*

BEHAVIORAL CONTROL • The primary factor of behavioral control involves instructions. *Id.* Treasury Regulations provide that professional workers who are engaged in an independent trade, business, or profession in which they offer their services to the public are independent contractors and not employees. Treas. Reg. §31.3121(d)-1(c)(2). However, most professionals are not providing services to the public independently, but on behalf of the practice where they work. While the instructions for professional services may be minimal, nearly all practices have policies covering operations to which the worker is subject. Types of instructions may include:

- When to do the work;
- Where to do the work;
- What tools or equipment to use;
- What workers to hire to assist with the work;
- Where to purchase supplies or services;
- What work must be performed by a specified individual; and
- What order or sequence to follow. IRS Publication 15-A (2010).

FINANCIAL CONTROL • Financial control considerations included the following:

- Does the worker have a significant investment in the business?
- Is he or she reimbursed for out-of-pocket expenses associated with the business?
- What is the method of payment to compensate the worker? and
- Will the worker directly share in the business profit and loss? PLR 200323022.

As to a significant investment, few professionals individually own the equipment in their offices or rent the equipment from the practice at fair rental value.

Independent contractors almost always have unreimbursed expenses and are generally free to seek out business opportunities. As such, independent contractors typically advertise, maintain a visible business location that they directly pay for, and are available to work in a particular market. IRS Publication 15-A (2010). However, in professional practice settings, the professional is almost always subject to restrictive covenants that restrict the ability to work in a given market, other than for the particular practice, thus further illustrating an employer-employee situation.

Professionals are frequently paid on a commission basis (as a function of productivity) and this does show evidence of an independent contractor relationship. However, it is the practice that customarily sets the fee schedule and bills the clients. This shows financial control. IRS Publication 15-A (2010).

If the worker is free to make decisions that affect the worker's profit or loss, the worker could be an independent contractor. Examples include types and quantities of supply inventory, the type and amount of monetary or capital investment, and whether to purchase or lease the premises or equipment. Training Materials, p. 2-21. In professional practice settings, professionals do not often have the ability to directly realize a profit or loss considering these factors. Although a professional can work longer or shorter hours (which affects profit), so can non-professional employees. Therefore, this hourly point is not too significant.

In professional practices, the practice almost always maintains controls over all financial and business aspects of its operation, including setting fees, billing the clients, collecting the fees, and paying operating expenses. Although it is possible for the professional to be an independent contractor if the worker sets the fees, bills the patients or clients, and pays rent for use of the premises and equipment, this in reality rarely happens.

RELATIONSHIP OF THE PARTIES • A nominal independent contractor agreement, in and of itself, is not sufficient evidence for determining a worker's status. Training Materials, p. 2-22. Under

the Treasury Regulation, the designation or description of the parties is immaterial. Treas. Reg. §31.3121(d)-1(a)(3). Therefore, the substance of the relationship, not the label, governs the worker's status. *Id.*

Frequently, professionals will incorporate themselves and will further provide that the worker is an employee of his or her corporation and not the practice. Just because a worker receives payment through his or her corporation does not mean that the worker will be found to be an independent contractor relative to the practice. *Id.* at p. 2-23. Incorporation, therefore, provides no substantive help in establishing independent contractor status.

The ability of the worker to quit or of the practice to freely terminate the services of the worker no longer has, in and of itself, significant bearing on whether the relationship is one of an employee or independent contractor relationship. The term of the relationship, however, may have an impact on worker classification. An indefinite term indicates an employer/employee relationship while a long term or temporary term may indicate either. PLR 200323022.

INTERESTING CASES • Below are some interesting cases that are relevant to whether the professional can be properly classified as an independent contractor under the three categories of control. *See* Tax Management Portfolios, BNA, Inc., 391-3rd *Employment Status – Employee v. Independent Contractor*, Helen Marmoll, Esq. p.A-47-A-139.

Accountants

In *Youngs v. Commissioner*, 96-2 U.S. Tax Cas. (CCH) ¶50,579 (9th cir. 1996), an accountant for National Maintenance Contractors, Inc. was an independent contractor. The accountant had approximately 25 other clients in the years in question and was paid on a job-by-job basis.

In Rev. Rul. 58-504, 1958-2 C.B. 727. an accountant who was not licensed as a CPA but who worked only for an accounting firm was an employee. The work was done under the firm's name and for the firm's clients. The accountant had no clientele of his own.

In Rev. Rul. 57-109, 1957-1 C.B. 328, the IRS found that an individual engaged in performing part-time bookkeeping and tax services for a company was an independent contractor. The bookkeeper determined his own hours, worked without supervision, and was not guaranteed a minimum compensation. Although permitted to use the corporation's business equipment without charge, the bookkeeper provided his own working papers and materials and paid his own expenses. The bookkeeper advertised his services in the city directory and newspapers and had other clients.

Anesthetists

In Rev. Rul. 57-380, 1957-2 C.B. 634, an anesthetist was held to be an independent contractor who contracted with two hospitals to provide services personally or by assistants paid by him when the need for services arose. Neither hospital issued instructions or directions, other than to advise him of the time for which operations were scheduled.

In Rev. Rul. 57-381, 1957-2 C.B. 636, an anesthetist who performed full-time and exclusive services during prescribed hours each week for a dental surgeon was an employee. The anesthetist worked in the office of the dental surgeon. Although she purchased her own supplies and kept separate records of her expenses and collections, the charges for her services were listed separately on the dentist's statements and constituted her sole remuneration. She did not maintain an office or make her services generally available to other practitioners. Her name did not appear on the dentist's letterhead or office door. The IRS found that the anesthetist was engaged by the dental surgeon to render professional services on a continuing basis, and such services were a necessary incident to the conduct of the dental surgeon's practice. Although

the anesthetist was qualified to perform the services without detailed supervision, the dental surgeon retained the right to control the services rendered to his patients even though it was not necessary for him to direct and control such services.

Athletes

In Tech. Adv. Mem. 86-25-003 (Feb. 28, 1986), professional athletes established "PSCs" through which services were made available to a professional "Team." The PSCs and the Team entered into contracts in exchange for exclusive services. The IRS reviewed the following factors to determine that the Team was the employer of the athletes: instructions; training; integration of a person's services into the business operation of the employer, ;whether the services must be rendered personally; payment in increments measured by time (hourly, monthly, etc.); payment of travel expenses; furnishing of tools (uniforms and equipment); the party investing in and furnishing the facilities used by the worker to perform the services (locker room and the back-up equipment needed to play); and control over availability of appearances and the right to discharge. The IRS noted that the payment by the Team to the PSCs rather than to the athletes did not negate the existence of an employer-employee relationship between the Team and the players. The PSCs were merely the agents for the receipt of compensation. The IRS concluded, despite the existence of the PSCs, that the Team exercised sufficient control over the athletes to be their common law employer. As such, the Team was liable for employment taxes, and subject to withholding, on all sums paid.

Taking markedly different positions on whether an athlete is an employee or independent contractor are Rev. Ruls. 68-625, 1968-2 C.B. 465, and 68-626, 1968-2 C.B. 466. Under Rev. Rul. 68-625, a golf professional was given the privilege of selling lessons and golf equipment on the premises of a golf club. The golf professional was furnished space in the caddy house and locker room and use of the club's telephone. His activities were confined strictly to golf instruction and the sale of golf equipment. Because the golf professional made his own appointments for lessons, fixed his own prices, and retained all remuneration received and bought and sold golf equipment in the same manner as that of a retail merchant without orders or instructions from any member or official of the club, and because the club had no right to direct him in the manner or method of performance of his services, he was an independent contractor.

Alternatively, under Revenue Ruling 68-626, a golf professional performed services at a country club and received a fixed salary each month. Further, the golf professional received the proceeds from the operation of the golf shop, which consisted of a certain amount every month for each bag of clubs cleaned and kept in the shop and the profits from the sale of balls, bags, and supplies. In addition, the golf professional instructed club members at an hourly rate established by the club. The club had the right to direct and control the manner in which the golf professional managed the shop. His books were open to club inspection at all times, he was required to be available for and to keep lesson appointments and to engage in such further help as required by the club. Accordingly, the golf professional was found to be an employee of the club.

Attorneys

Under Rev. Rul. 68-324, 1968-1 C.B. 433, an associate attorney worked at a law firm and was paid a fixed annual salary. The attorney was furnished office space, stenographic help, was required to work daily hours, and was engaged mostly in research work that was assigned by the firm. Even though the attorney handled certain assigned cases from the firm for which the attorney received additional fees, the attorney was an employee.

In *Van Camp & Bennion P.S. v. United States*, 96-2 U.S. Tax Cas. ¶50,438 (E.D. Wash. 1996), the IRS

concluded that one shareholder who handled the majority of corporate duties and whose name and reputation were instrumental in bringing in clients was an employee. The other shareholder who performed *de minimis* administrative duties, worked on a very limited basis, made no written reports to the practice, and did not make time entries was an independent contractor.

Barbers And Hair Stylists

A barber who rents a chair for a fixed weekly fee, furnishes his own barbering tools, determines his own work routine, is not required to perform a minimum amount of work or be on duty a specified number of hours, retains all fees collected by him, is not required to make an accounting to the barbershop owner, and was free to terminate the rental agreement at any time (as was the shop), is an independent contractor. Rev. Rul. 57-110, 1957-1 C.B. 329.

A beautician who rents a booth in a beauty shop for a fixed monthly fee, sells and styles wigs that she purchases herself, retains the proceeds, is not guaranteed a minimum amount, is free to select her own customers and set her work schedule, is not required to adhere to the salon's rules, is required to clean her own work area, furnish her own uniforms, and maintain her own tools is an independent contractor. Rev. Rul. 73-592, 1973-2 C.B. 338.

However, compare Rev. Rul. 73-591, 1973-2 C.B. 327, where the beautician was held to be an employee. Here, the beautician leased space from the beauty salon, was required to be at her chair at 8:00 a.m. on days scheduled to work, and was paid a percentage of the fees taken in by her where such fees were set by the beauty salon. The percentage of fees was based upon daily receipts furnished to the beauty salon.

Consultants

In *Fuller v. Commissioner*, 9 B.T.A. 708 (1927), the taxpayer was engaged by municipalities to perform services as a consulting engineer. Because the taxpayer was free to accept other engagements and was left to use his own judgment, discretion, and professional skill to bring the desired result without direction or control of the municipalities that engaged him, he was an independent contractor.

Dental Hygienists

In Rev. Rul. 58-268, 1958-1 C.B. 353, a hygienist was paid 50 percent of production under an oral contract. She did not secure patients but did arrange recall visits and completed charting. She did work for other dentists. Although the hygienist was qualified to provide the hygienic services without instructions and used her own discretion with respect to treatment methods, the dentist paid for all expenses, provided office space, and furnished all supplies and equipment. Under the facts, the dental hygienist was an employee.

Dentists

In *Queensgate Dental Family Practice, Inc., v. United States*, 91-2 U.S. Tax Cas. (CCH) ¶50,536 (M.D. Pa. 1991), the dentists were independent contractors. The dentists set their own fees, determined their own schedules, directed staff and planned their own patient treatment. They ordered supplies separately, consulted and referred to other dentists as they deemed appropriate, separately determined how to handle patients that did not pay, maintained records separately, paid their own entertainment and travel expenses, paid for their own malpractice insurance and continuing education costs, and risked the possibility of lost profits which were based exclusively upon the compensation received from each dentist's patients. If the government had inquired as to whether restrictive covenants existed between the dentists and the practice, the court may have found the dentists to be employees.

In Tech. Adv. Mem. 93-21-001 (Feb. 1, 1993), dentists were found not to be similar to the independent contractors in *Queensgate* and the taxpayer was

not entitled to relief under section 530 of the Revenue Act of 1978 with respect to employment tax liability arising from the services of the dentists.

Physicians

Under Rev. Rul. 72-203, 1972-1 C.B. 324, physicians paid by and working full-time for a hospital's pathology department were employees. Their services were completely integrated into the operation of the pathology department, they performed substantial services on a regular and continuing basis, and the department had the right to fire them if they did not comply with the general policies of the pathology department.

Under Rev. Rul. 61-178, 1961-2 C.B. 153, a physician was found to be an employee. Although the physician maintained a private practice, he also regularly rendered medical treatment to employees of a company on its premises on a part-time basis, was required to conform to the company's policies and procedures, was subject to supervision by the company's head physician, worked a fixed schedule, and was provided benefits consistent with the company's regular employees.

In *Dutch Square Medical Center Limited Partnership v. United States*, 94-2 U.S. Tax Cas. (CCH) ¶50,490 (D.S.C. 1994), a physician/medical director was held to be an employee of an urgent care facility due to the facility's control over the medical director's activities despite the fact that the medical director was paid through his own professional corporation. It did not help that the medical director's professional services corporation was not formed until after his employment commenced with the urgent care center. However, this would probably not have mattered due to the facility's control over his activities.

In *Azad v. United States*, 388 F.2d 74 (8th Cir. 1968), a radiologist was held to be an independent contactor. The radiologist was not restricted to performance of services solely for one hospital and did work for other hospitals. Neither the head of the radiology department nor the hospital exercised any supervision over the professional services of the radiologist and the radiologist was not required to work set hours nor account for absences from work. Finally, none of the radiologists in the department were required to comply with any set policies, rules, or regulations of the hospital.

In Technical Advisory Memorandum 94-43-002 (Dec. 3, 1993), a radiologist and other physicians were found to be employees. The hospital contracted with the radiologist to provide services to patients, provided a fully equipped and staffed department, and compensated all personnel. Although the radiologist billed the patients, the hospital collected the fees and compensated the radiologist, under a guaranteed minimum income, and paid two-thirds of the radiologist's family health insurance premiums. The radiologist was required to visit the hospital at least once per day and be on-call at other times. The radiologist and the other physicians devoted their primary efforts to serving the hospital's patients and were prohibited from competing with the hospital in its geographic area. It was concluded that the radiologist was under the hospital's control, was integrated into the hospital's business, had no investment in the business of the hospital or its buildings, had a continuing relationship with the hospital, and did not work for unrelated firms or hospitals.

In *Professional & Executive Leasing, Inc. v. Commissioner* 89 T.C. 225 (1987), *aff'd*, 862 F.2d 751 (9th Cir. 1988), management and professional workers were found not to be employees of the management leasing company that attempted to provide liberal retirement plans to the workers as employees. The court found that the leasing company did not exercise control over the workers, had no investment in the facilities of the workers, had no opportunity for profit or loss except for set-up fees and monthly service rate payments, had no right to discharge the workers, and had no employment relationship with them despite nominal employment agreements.

The leasing company merely provided bookkeeping and payroll services. This case is interesting because the workers failed to obtain the favorable retirement plans that they were promised because they were not the leasing company's common-law employees.

CONCLUSIONS • Let's return to the three practice scenarios mentioned at the beginning of the article.

The New Professional

The fact that the new professional practices through a corporate entity, typically an S-corporation, does not mean that the new professional is not an employee of the professional practice. Typically, the practice and its owner retain a substantial degree of control, including mentorship, over the new professional, including setting fees, billing clients, providing clients and referral sources, establishing practice systems, and scheduling. Almost always, the new professional has a covenant not to compete, which arguably in and of itself shows behavioral control. With few exceptions, equipment is provided by the practice, hours of work and patients or clients are scheduled by the administrative staff, and the new professional has no investment in the practice facility and no risk of loss. Finally, the parties often contemplate future ownership of the practice, in whole or in part.

The Retiring Professional

The retiring professional usually renders professional, consulting, and administrative services to the new owner of the practice on those days, times, and hours per week and for compensation as mutually agreed to by the parties, subject to the needs of the new owner. Often, the retiring professional will agree to remain in the practice for a period of six months or a year and by mutual agreement thereafter. However, the new owner should retain the ability to terminate the relationship at any time after the transfer of goodwill is complete. Although there is a good argument that the retiring professional is an independent contractor because the new owner does not need to train the retiring professional, the practice typically maintains control over the retiring professional's activities. In this case, the new owner's practice bills the patients or clients, collects revenue, sets the fees, employs the staff, and provides the equipment to the retiring professional. The new owner's systems and policies are in place, which may or may not be the same systems and policies that the retiring professional used. Finally, the retiring professional will almost always be subject to a restrictive covenant which shows behavioral control.

The retiring professional usually would like to be an independent contractor so that business expenses not paid by the practice can be fully written off. For example, retiring professionals are usually paid more than an associate new professional, e.g., 35 percent of adjusted production or collections, versus 30 percent to an associate. As such, the practice may claim it cannot afford to pay the retiring professional's health insurance, malpractice, continuing education, professional dues and licenses, entertainment, or other direct business expenses. Due to the control exercised by the new owner's practice over the provision of services by the retiring professional, it is unlikely that the retiring professional is an independent contractor. A more substantively correct and practical approach would be to have the retiring professional treated as an employee of the practice, have the practice directly pay the business expenses of the retiring professional, and reduce or offset the retiring professional's compensation by the full cost of such expenses.

Three-Entity Approach

Under the three-entity approach to co-ownership, the new owner purchases one-half of the old practice owner's tangible assets and the old practice owner's personal goodwill. Each owner is the sole

shareholder of a professional corporation which contracts with a newly formed limited liability company, owned by the corporations, to provide professional services to the public. The limited liability company bills patients or clients, collects revenue, employs the staff, adopts the retirement and medical plans, and pays the operating expenses. Profits are distributed to the respective professional corporations. The professionals are nominal employees of their respective corporations, but are they really employees of the limited liability company? Because the limited liability company bills the clients, pays expenses, employs staff, maintains fringe benefit plans, and establishes fees and office policies and systems, the professionals may be employees of the limited liability company or be deemed direct owners of it, and the interposed corporations could be disregarded, with the consequence that net operating profits are self-employment income subject to FICA and Medicare taxation. The IRS is attempting to figure out what to do with this increasingly popular approach.

The three-entity approach is also being promoted in an attempt to provide amortization for purchased goodwill by the incoming owner. There are, however, a number of issues to consider aside from worker classification. These include characterization of personal versus corporate goodwill and the valuation thereof, the anti-churning regulations under IRC section 197 that prohibit goodwill from being amortized by the new professional for a buy-in of a practice formed pre-1993, and the amortization for the buy-in and buy-out or complete sale of assets of a family member in a practice formed pre-1993.

Focusing again on the worker classification issue, for a professional to solidify independent contractor status in the professional practice setting, the professional should bill the patients or clients to which it, he, or she provides services, pay rent for use of the premises, perform administrative services, maintain the ability to control fees and hours, make an investment in equipment, not be subject to a restrictive covenant, not be subject to office policies and procedures, and schedule its, his, or her patients or clients. Although these factors are based on facts and circumstances and are a matter of degree, the more factors, the better the chances of a favorable finding. Obviously, not many professional relationships meet the criteria necessary for a finding that the professional is an independent contractor, a crucial finding in today's environment when the Internal Revenue Service plans to audit 6,000 U.S. companies to determine whether such companies pay all required employment taxes, including a determination of whether workers are classified correctly. Ryan J. Donmoyer, Bloomberg.com, *IRS to Audit 6,000 Companies to Test Employment Tax Compliance* (September 18, 2009), www.bloomberg.com/apps/news?pid=20670001&sid=anpR2t09GIeU (Feb. 5, 2010). Accordingly, except in rare circumstances, the advisor should be very cautious of finding a proper independent contractor relationship in professional practice settings because if the practice is audited, it has probably already lost due to the cost of defense.